NOVA SCOTIA
Department of Finance

Nova Scotia Tax Credit Review

Phase II Report Highlights

Nova Scotia Department of Finance
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Phase II Tax Credit Evaluation Summary

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Introduction

In the 1999-2000 Budget Address, the Minister of Finance stated that his department would review all provincial tax credit programs.

"Over the years we have developed many tax credits, tax expenditures, and rebates. We have tax rebates for fire trucks and new homes. We have tax credits for research and development and for buying a new piece of machinery. My department is now working on a report that will show the costs and benefits associated with each such measure. We will put them on the table for public comment. Tax credits that have become tax loopholes will be closed."

The completion of the Phase II Tax Credit Evaluation is the final step in meeting that commitment.

This report is a summary of the Phase II Tax Credit Evaluation. The full report is available on the Department of Finance Web Site at **www.gov.ns.ca/fina**. If you have questions about this report, you can contact Mike Queripel at 424-7379.

The Review Process

Work on the Phase II evaluations began in May 2000. It included the following credits:

- New Small Business Tax Deduction
- Equity Tax Credit (re-evaluation based on updated data)
- Labour-Sponsored Venture-Capital Corporations Tax Credit
- HST Rebate for New Housing
- HST Rebate for Persons with Disabilities
- HST Rebate for Printed Books
- HST Rebate for Volunteer and Municipal Fire Departments

The evaluation involved the following steps:

- Determining information requirements and compiling an inventory of available information.

- Identifying information shortfalls and taking steps to gather required information. This included gathering information from program participants through surveys and focus groups.
- Analysing economic impact where appropriate.
- Comparing program objectives to outcomes.
- Making recommendations based on the effectiveness of each program and the relevance of its objectives.

The summary report concerns itself with the last three of these steps. Details of the methodology appear in the full report.

Economic Impact Analysis

The economic impact analysis was conducted using the Nova Scotia Input Output System (NSIO). Impact simulations were performed on investment expenditures associated with the credit. If appropriate, the annual operations associated with the investment were analyzed. Investment expenditures are one-time expenditures and therefore have one-time impacts. As long as the company is in operation, impacts associated with annual operations occur yearly. Impacts are reported for household income and employment (person-years) and provincial tax revenue (personal income tax and spending tax). Corporate income tax is not included. Impacts are also divided into three categories:

- Direct impacts: the direct result of the company's expenditures on goods and services in Nova Scotia.
- Spin-off impacts: the sum of indirect impacts (caused by inter-industry transactions) and induced impacts (caused by household spending).
- Total impacts: the sum of direct and spin-off impacts.

Financial cost-benefit analysis compares total estimated provincial government revenue to provincial government expenditures.

Tax Revenues and Credits

Personal and corporate income is taxed to raise revenues for the province. The taxation system is also used to achieve economic and social objectives. Tax credits are one method used to achieve these objectives. Tax credits are provincial expenditures that reduce the amount of income tax payable.

Tax credits may be either refundable or non-refundable. Refundable tax credits allow a company or individual to receive the full amount of the tax credit, regardless of the amount of tax payable. A non-refundable tax credit reduces tax only up to the amount of tax payable.

Tax credit expenditures have tripled since 1995. The value of personal and corporate tax credits will grow to $69.5 million in the 1999 taxation year. If left unchanged, this growth will reach over $100 million in the next two years. Given these expenditures, it is vital that the government review tax credit programs to determine if these programs are meeting its objectives in a cost-effective manner.

The following table shows the cost to the province, in each the last three years, of the tax credits under review in this phase:

Value of Credits (Estimate March 2000)

Credit	1997 ($ 000)	1998 ($ 000)	1999 ($ 000)
NSB	700	700	700
ETC	2,400	1,900	2,500
LSVCC	400	500	500
HST: New Housing Rebate	2,400	4,100	
HST: Persons with Disabilities Rebate	200	200	200
HST: Printed Books Rebate		5,000	
HST: Volunteer & Municipal Fire Department Rebate	17	36	126

New Small Business Tax Deduction

The New Small Business Tax Deduction, designed to assist new small businesses during start-up, came into effect April 18, 1986. It effectively eliminates the Nova Scotia corporate income tax for the first two taxation years of a new small business incorporated after April 18, 1986 and for three years for a new small business incorporated after April 24, 1992. Corporations must meet eligibility requirements and must apply each year.

The deduction helps Nova Scotia businesses during start-up by providing additional working capital. The measure is intended to increase the success rate of new small businesses and, in turn, increase employment and tax revenues in the long run. Through the end of 1998, 1,773 small businesses had qualified for 2,585 certificates worth $7,083,986.

The program was evaluated based on a survey of Nova Scotia small businesses and on an examination of survival rates for participating firms. The survey showed that firms that received the deduction were slightly more likely to report an increase in profitability than other respondents, but no more likely to report an increase in either full-time equivalent employees or payroll expenditures. The most important benefit of the deduction, as reported by firms that received it, was that it increased their working capital.

There is some indication the deduction may not have a strong incremental value. The majority (92 per cent) of firms surveyed did not compare investment opportunities in other provinces. "I

live in Nova Scotia" was most often cited as the reason respondents chose to locate their business in Nova Scotia. "Proximity to market" and "quality of life" were most often cited as the second most influential reason for choosing Nova Scotia.

New Small Business Tax Deduction recipients had a higher survival rate than the population of firms incorporated from 1986-99. As a group, they had a 72 per cent survival rate, compared to 55 per cent for all companies. The group of tax credit recipient companies are not necessarily representative of the larger population they were compared to. They might differ from the total population in ways that would tend to increase their survival rates apart from the effect of the tax credit.

Policy Decisions

The New Small Business Tax Deduction program will continue. To maximize the benefits of the program and to target expenditures to corporations that will have the greatest impact on job creation, the following administrative changes will be made:

- The credit will be limited to corporations that have at least two employees, one of which cannot be related to a shareholder of the firm.
- As with other jurisdictions, applicants will be required to claim all possible corporate deductions and credits in the year prior to calculating the New Small Business Tax Deduction.
- If corporations receive a refundable credit for a given tax year, they will not be eligible for the New Small Business Tax Deduction.
- Corporations will have three years after the end of the taxation year to apply for a deduction for that year.

Equity Tax Credit

The Equity Tax Credit (ETC) program, introduced in 1994, provides a 30 per cent tax credit for investments in qualified small businesses, co-operatives and community economic development investment funds (CEDIFs). The maximum annual tax credit is $9,000 per individual. The ETC is non-refundable, but unused amounts may be carried forward seven years and back three years.

The Equity Tax Credit program has two principle components. The first is the 'General ETC' program, which applies to direct investments in corporations or co-operatives and which is set to expire in December 2001. The second component, the CEDIF component, applies to investment in community economic development investment funds. The CEDIF program is set to expire in December 2003.

From its inception in 1994 through to February 2000, 277 companies and 2,985 investors have participated in the equity tax credit program. Participants have invested $31.5 million and received $9 million in credits. Three CEDIFs were established in Nova Scotia during 1999. These funds raised $1.1 million of the $9 million raised under the ETC in 1999.

The Equity Tax Credit program was reviewed as part of the Phase I report. That report recommended that the CEDIF program be extended to December 2003, but that recommendations on the general ETC program be postponed until Phase II so that more information could be

incorporated into the economic impact study. The original economic impact study included the years 1994 through 1997. The 1998 and 1999 years have been added for the current study.

The ETC studies conducted in both phases of the program review indicate that the program has had a positive impact on participating companies and has generated net revenues for the province.

Over 90 per cent of respondents agreed the ETC encouraged them to seek equity financing rather than borrow; 89 per cent indicated it allowed them to obtain equity financing that was otherwise unavailable. Three-quarters of respondents stated they could not have started or expanded their business without the ETC.

Of all companies certified under the ETC between 1994 and 1999, 88 per cent were still in business as of November 1, 2000. By comparison, 72 per cent of all companies incorporated between 1994 and 1999 were still in business as of November 1, 2000.

A study of 31 firms showed that most improved in terms of revenue, payroll expenditures, and liquidity ratios in the two years following certification.

ETC investments made during 1994-99 will generate a positive cash flow to the provincial treasury by 2001. This payback is very favourable, especially compared to commercial appraisals, which use a five-year payback as the basis for undertaking an investment.

Policy Decisions

The General ETC program will be extended to December 31, 2003, the same end date as for the CEDIF program.

Labour-Sponsored Venture Capital Corporation Tax Credit

The Labour-Sponsored Venture Capital Corporation (LSVCC) Tax Credit is a 15 per cent personal tax credit for investments in labour-sponsored venture capital corporations registered in Nova Scotia. Individuals may receive a maximum provincial credit of $525 (based on a maximum investment of $3,500) per year. Individuals may also receive a 15 per cent federal tax credit up to $750 per year. The credit is not refundable and cannot be carried forward to future years.

A labour-sponsored venture capital corporation (LSVCC) is a venture capital investment fund sponsored by a labour organization. It has a general aim to create employment by making capital available to small and medium-sized businesses. Theoretically, LSVCCs differ from traditional venture capital funds in that the LSVCC has significant mandates apart from achieving the highest return for investors. Canadian governments have encouraged the development of these funds by providing individual tax credits for investments in LSVCCs.

The Labour-Sponsored Venture Capital Corporation Tax Credit program was started in 1994. Up to 1999, approximately $7.5 million in tax credits have been claimed. Funds registered in Nova Scotia have raised approximately $38.6 million in the province since 1994. The funds are required to place a minimum of 60 per cent of all moneys raised in Nova Scotia with Nova Scotia businesses. This results in a total minimum LSVCC pool of about $23.2 million (60 per cent of $38.6 million) as of December 31, 1999.

The LSVCCs have reinvested about 41 per cent of all funds raised and 68 per cent of the $23.2 million provincial pool. The $15.8 million in reinvestments have been made in seven different projects, for an average placement of about $2.3 million.

On average, it takes the LSVCCs three-and-a-half years to reinvest funds raised in the province. Venture capital deals focus on long-term growth, so it may be another four or five years before the investment begins to show significant returns in the form of corporate tax revenue and employment expenditures. Given these two factors, it may be several years before the government benefits from the tax expenditure.

In evaluating this tax credit program, the department consulted with local venture capitalists. They indicated that the province is gaining a national reputation as a technology centre and is attracting venture capital from outside the region. Local venture capitalists are confident these trends will continue. A frequent comment is that 'good' projects are receiving financing.

Local venture capitalists indicate that personal tax credits may be required to ensure that new venture capital is available. They stress, however, that private fund managers must be free to make investment decisions and that government should not impose an economic development mandate.

Full details of the consultations can be found in the full report.

Policy Decisions

The LSVCC Tax Credit will be sunset as of December 31, 2003. The program will be evaluated before this date to determine whether it should be extended.

Pacing requirements will be amended: registered LSVCCs will have to reinvest 60 per cent of funds raised in the province in eligible businesses within two years instead of the current four years.

HST Rebate: New Housing

The New Housing Rebate was introduced in 1997 as part of the harmonized sales tax (HST). The rebate was intended to replace the First Time Home Buyer's rebate offered under the former health services tax. The New Housing Rebate equals 18.75 per cent of the provincial HST owing (or 1.5 percentage points of the 8 per cent tax) on new housing construction, to a maximum of $2,250 per unit. This maximum per-unit rebate is reached at a new house price of $150,000. All new houses are eligible for the credit, regardless of price.

The former First Time Home Buyers' Rebate cost $3,997,902 in 1995-96 and $9,252,348 in 1996-97. The dramatic increase in 1996-97 can be attributed to the fact that potential homebuyers were aware the program was ending, but unsure whether there would be a replacement program. This prompted many homebuyers to accelerate their purchasing decisions.

The New Housing Rebate cost $2,442,442 in 1997. Since the credit was introduced in April 1997, the 1997 figure includes data from April 1 to December 31, 1997. In 1998, the program cost $4,150,222.

The number of maximum claims ($2,250 per unit) is only 13.5 per cent of the total number of claims. This suggests that the majority (86.5 per cent) of claims were for housing less than $150,000.

The New Housing Rebate has two basic objectives.

The first is economic: to neutralize the effects of implementing the HST on the price of new housing. The HST on housing construction represented an added cost for consumers. A temporary measure was needed to ensure that residential housing starts were not unduly affected before the market had a chance to adjust to the changes.

The second is social: to make home ownership more affordable for moderate-income families.

The New Housing Rebate was introduced in part to help neutralize the effects of the implementation of the HST on the price of new housing by effectively lowering the price paid for housing by a maximum of $2,250 per unit. It was assumed that the additional cost to the builder would hurt housing starts in the province. The growth rate in residential housing starts in Nova Scotia generally corresponds with activity nationally.

Housing starts declined in Nova Scotia by 13 per cent from 1996 to 1997 and by 21.4 per cent from 1997 to 1998. Housing starts across the country increased during this period. From 1998 to 1999 housing starts increased 40 per cent in Nova Scotia. This exceeded the 7.1 per cent growth rate across Canada during the same period.

In addition to economic considerations, the New Housing Rebate is intended to make home ownership affordable for moderate-income families. The federal and provincial rebates have had the positive social benefit of providing many families with a down payment for their first home.

The rebate is currently available to all home builders regardless of the cost of the home. The relative value of the credit to the home builder decreases as the price of the home increases. For example, on a $150,000 home, the rebate represents 1.5 per cent of the purchase price. On a $250,000 home, the maximum rebate represents less than one per cent of the purchase price. In the context of scarce resources, fairness and equity would suggest that the government should assist those families that most need financial help to become homeowners.

The average fair market value of a new home, based on the 1998 rebate claims, was approximately $124,000. A new housing rebate threshold of $100,000 for first-time homebuyers would ensure that those families most in need would receive the benefit.

This measure would not reduce the total amount of housing starts, since families who need the rebate as a down payment would still receive it. Most individuals buying their second home use existing equity for their down payment.

Policy Decisions

The New Housing Rebate will be amended as follows:

- The maximum rebate claim is reduced to $1,500 ($100,000 purchase price).

- The rebate will be limited to first-time home buyers.
- The new rules will start on January 1, 2002. Transitional rules will be developed to ensure individuals buying new homes during the current construction period will not be affected.

HST Rebate: Persons With Disabilities

The HST Rebate for Persons with Disabilities was introduced in April 1998 to replace similar tax relief provided under the health services tax (PST). The rebate applies to purchases of vehicles for people with disabilities that prevent them from using their legs.

The HST rebate is 100 per cent of the provincial portion of the HST, or 8 per cent. The maximum rebate is $3,000, reached when the vehicle costs $37,500. Vehicles with a purchase price above this amount are still eligible for the maximum rebate.

Arguments supporting the HST Rebate for Persons with Disabilities are based primarily on the principle of fairness. People with disabilities pay more for personal transportation. Auxiliary driving controls and wheelchair lifts can cost up to $10,000. Personal transportation is a basic requirement for access to employment opportunities and public services. The tax rebate reduces some of the additional costs people with disabilities incur to pursue activities that are available to other citizens.

When the tax measure was introduced, the government projected that the annual cost of the rebate be about $200,000. The actual yearly costs for this program is:

- $224,432 for 1997-98
- $166,018 for 1998-99
- $150,368 for 1999-2000

The costs of the HST Rebate for Persons with Disabilities has not exceeded projected program costs.

Policy Decisions

The HST Rebate for Persons with Disabilities will be continued.

HST Rebate: Printed Books

The HST Printed Book Rebate offers a 100 per cent point-of-sale rebate of the provincial portion of the HST, or 8 per cent. The rebate applies to the purchase of printed books, audio recordings of printed books, printed versions of scriptures of any religion, and periodicals that have less than 5 per cent of the total printed space dedicated to advertising. There is no limit on the amount of the HST rebate.

The rebate was introduced in 1998 to replace similar tax relief provided under the health services tax (PST). The HST rebate rules are essentially the same as the former PST rules, except that the PST provided an exemption from tax as opposed to a tax rebate. The end result for the purchaser is the same: the individual pays no provincial sales tax on the purchase of qualified products.

The government projected that the HST Printed Book Rebate would cost about $5 million each year. Since the HST rebate is a point-of-sale rebate, there is very little administrative data because the tax return filed by a HST registrant does not require that they provide details regarding their point-of-sale rebate claim. The cost of the rebate must be estimated using relevant economic data.

The HST Printed Book Rebate cost about $5.02 million in 1998. The costs of this rebate are in line with original estimates.

Policy Decisions

The HST Printed Book Rebate will be continued.

HST Rebate: Volunteer And Municipal Fire Departments

The province introduced the Volunteer and Municipal Fire Department Rebate in 1998. The rebate is available to volunteer fire departments and municipalities on the purchase of firefighting vehicles and heavy equipment. The rebate was intended to replace special tax relief provided under the former health services tax (PST).

The Volunteer and Municipal Fire Department Rebate is designed to top-up the existing Public Sector Body Rebates that volunteer fire departments (50 per cent rebate) and municipalities (57.14 per cent rebate) qualify for under the HST. When the Public Sector Body Rebates are combined with the provincial HST rebate, volunteer fire departments and municipalities effectively receive a 100 per cent rebate.

Volunteer fire departments receive a 50 per cent rebate on the provincial portion of the HST paid, to a maximum of $7,400. Municipalities receive a 42.86 per cent rebate on the provincial portion of the HST paid, to a maximum of $6,343.28. These maximum rebate amounts are reached on the purchase eligible equipment of $185,000. Vehicles with a purchase price above this amount are still eligible for the maximum rebate.

The primary rationale for the Volunteer and Municipal Fire Department Rebate is that tax relief should be provided for purchases of emergency vehicle equipment. Volunteer and municipal fire departments provide a vital public service. A sales tax on this equipment would serve as a disincentive to volunteer fire departments purchasing new equipment.

The government projected that the Volunteer and Municipal Fire Department Rebate would cost about $500,000 each year. The rebate actually cost:

- $17,025 for 1997-98
- $36,373 for 1998-99
- $126,177 for 1999-2000

The cost of this program varies from year to year because purchases of new firefighting equipment represent a significant capital investment that is not incurred by volunteer and municipal fire departments annually.

Policy Decisions

- The volunteer and municipal fire department rebate will be continued.
- The existing Sales Tax Act Regulations will be amended to correct an error in the existing erratum.

Related Issues

This report represents the completion of Phase II of the Nova Scotia Tax Credit Review. Some tax credit reviews are ongoing. The film industry tax credit is being reviewed and an independent business climate review is under way to provide government with a broader understanding of the business climate in this province compared to other jurisdictions. Other tax-credit-related incentives, which have not been included in either Phase I or II of the review, will be studied in 2001-02.

Film Industry Review

The film industry tax credit was evaluated as part of Phase I of the Nova Scotia Tax Credit Review. At that time it was decided that there would be continued work on both the equity tax credit program (which has been included in this report) and the film industry tax credit. A separate process to review the film industry in the province is now under way and the results of this work are expected by March 2002. The program is set to expire on December 31, 2002 and the study will attempt to provide an understanding of the costs and benefits associated with the provincial film industry.

Business Climate Review

The department is reviewing the Nova Scotia business climate in order to gain a better understanding of how Nova Scotia's business climate compares to that of other jurisdictions.

The study will determine the total cost of doing business in Nova Scotia (with particular emphasis on taxation) and will compare it to the total cost in other jurisdictions. Taxation considerations will include both personal and corporate taxation. The study will include an analysis of:

- Taxation rates
- Labour costs and markets
- Transportation infrastructure
- Capital costs
- Operating costs
- Availability of capital
- Regulatory environment
- Industrial capacity
- Knowledge capacity
- Lifestyle considerations

Small Business Tax Reduction

The small business rate reduction will be reviewed as part of the business climate report.